United States Court of Appeals

for the Second Circuit

PETITION FOR REHEARING EN BANC

Court Original

76-7259

United States Court of Appeals

FOR THE SECOND CIRCUIT

THOMAS J. BYRNES and FRANCIS R. SANTANGELO,
Plaintiffs-Appellants,

—against—

FAULKNER, DAWKINS & SULLIVAN and SINGER & MACKIE, INC.,
Defendants-Appellees.

FAULKNER, DAWKINS & SULLIVAN,
Counterclaim-Plaintiff, Appellee, Appellant,

—against—

THOMAS J. BYRNES and FRANCIS R. SANTANGELO,
Counterclaim-Defendants, Appellants, Appellees,

and

TOBEY & KIRK,
Counterclaim-Defendant-Appellee.

PLAINTIFFS-APPELLANTS' PETITION
FOR REHEARING EN BANC

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UNITED STATES COURT OF APPEALS
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PLAINTIFFS-APPELLANTS' PETITION
FOR REHEARING EN BANC

Pursuant to Rule 35(b) of the Federal Rules of Appellate Procedure, Plaintiffs and Counterclaim-Defendants-Appellants Thomas J. Byrnes and Francis R. Santangelo ("plaintiffs") respectfully move for rehearing en banc of this Court's decision filed March 1, 1977, which affirmed the entry of a final judgment for Defendants-Appellees upon a decision of Hon. Henry F. Werker, U.S.D.J., reported in 413 F.Supp. 453 (S.D.N.Y. 1976).* The Panel also affirmed the dismissal of counterclaims asserted by Defendant-Appellee-Cross-Appellant

*In its brief in this Court (p. 63, nt.) Faulkner suggested that plaintiffs appealed the dismissal of their complaint for declaratory judgment, 362 F.Supp. 864 (S.D.N.Y. 1973), solely in order to disqualify Hon. Murray I. Gurfein, U.S.C.J., who entered that decision while he was a member of the Southern District Bench. Plaintiffs unequivocally and without reservation waive any objection to Judge Gurfein's participation in any en banc review which the Court may be disposed to grant.

Faulkner, Dawkins & Sullivan ("Faulkner") because of the lack of damage.

Both the Panel and the District Court held that plaintiffs' contract for the sale to Faulkner of 44,000 registered shares of White Shield Corporation was unenforceable because, following the sale, plaintiffs' broker, Tobey & Kirk, in sending its "comparison" to Faulkner, then a market-maker in the stock, failed to accompany it with a copy of the prospectus, which was delivered with the securities, on the settlement date seven days later. The rationale is that because the "comparison" literally "confirms the sale of any security," and so is defined as a "prospectus" in section 2(10) of the Securities Act, 15 U.S.C. § 77b(10), and it obviously does not contain all of the information required in a formal prospectus. Faulkner had rejected the trade on different grounds, as to which Judge Werker gave summary judgment to plaintiffs.

The Panel affirmed despite some legislative history which suggests that notwithstanding a "comparison" literally confirms a sale, it need not be accompanied by a prospectus. It did so on unprecedented grounds: It held that plaintiffs were "underwriters" <u>because</u> their stock was included in a registration statement; that as underwriters they could not claim the "unsolicited brokers' transaction exemption of section 4(4) of the Act, 15 U.S.C. § 77d(4); and that Tobey & Kirk was a "dealer," within the definition of "dealer" in section 2(12), 15 U.S.C. § 77b(12), and therefore not entitled to claim that exemption.

Finally, the Panel rejected plaintiffs' suggestion that as a market-maker Faulkner must be presumed to have possession of a prospectus in a security in which it is making a market. In so holding, the Panel did not consider other Defenses, which disclose that plaintiffs had put Faulkner on notice that their shares were registered, and that as a market-maker, Faulkner might have been under a duty to keep itself aware of registered distributions in securities in which it was making a market.

Plaintiffs respectfully submit that the Panel's decision is contrary to the statute, unsupported by the authorities it cites, is inimical to an orderly securities market, and should be recalled or reversed.

POINT I

THE PANEL'S HOLDING EQUATING THE REGISTRATION OF STOCK WITH BEING AN "UNDERWRITER" AND DEPRIVING PLAINTIFFS AND THEIR BROKER OF THE § 4(4) DEFENSE HAS NO STATUTORY OR DECISIONAL JUSTIFICATION AND SHOULD BE WITHDRAWN

The dispositive holding of the Panel which we believe warrants review by the full Court is the passage appearing at Slip.Op. 2095-96, in which the Panel concluded that plaintiffs were "underwriters" because they registered their stock, that they therefore could not invoke the brokers' exemption and that their broker was a "dealer" in any event. We examine these three elements separately.

The Panel's rationale for deeming plaintiffs to be underwriters is as follows:

> "Appellants were themselves distributing stock in a registered offering, which makes their position quite different from that of the broker in Question No. 8 of the 1941 general counsel's opinion, on which appellants rely, see note 4 supra. . . . The definition of underwriter in Section 2(11), 15 U.S.C. § 77b(11), includes one who 'participates or has a direct or indirect participation in any [distribution of any security by an issuer], or participates or has a participation in the direct or indirect underwriting of any such undertaking.' Appellants and their associates arranged to have their stock included in one of the White Shield registration statements and were identified as putative underwriters in the White Shield prospectus. Appellants therefore became participants in the White Shield distribution and accordingly became underwriters. . . ."

We believe that this holding confuses cause and effect. As the Fifth Circuit recognized in Vohs v. Dickson, 495 F.2d 602, 620 (5th Cir. 1974), one who sells stock for his own account is not an underwriter within the meaning of section 2(11), unless he purchased the stock from the issuer with a view to a public offering, which usually involves a question of fact:

> "Under 15 U.S.C. § 77b(11), 'The term "underwriter" means any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security. * * *' The word 'distribution' as used in this definition is considered to be synonymous with 'public offering.' 1 Loss, Securities Regulation 551 (1961). Since Dickson sold for his own account, not for the issuer, he was an underwriter only if he purchased 'with a view to' a public offering of MSA stock.
>
> "Whether or not Dickson purchased with a view to a public offering is a question of fact which the district court answered in the negative after considering all of the circumstances." (Emphasis added).

Moreover, as the SEC recognized in Matter of Collins Securities Corp., CCH Sec.L.Rep. ¶ 80,327, at p. 85,800 (1975), the term "distribution" is nowhere defined in either the Securities Act or the Exchange Act, and its meaning and applicability to par-

ticular person should be derived from the statutory purposes for which it is used:

> "The Securities Act contemplates that registration will be required, absent some special exemption, when securities are publicly offered by or on behalf of an issuer or are purchased from an issuer for public resale, and the term 'distribution' as used in the Act has been interpreted to accomplish that purpose."

Thus, as construed by the Commission, the term "distribution" itself presupposes an offer or sale for an issuer, or a purchase from an issuer with a view to public resale.

In holding that plaintiffs were underwriters because they registered their stock, the Panel relied (Slip.Op. 2095) on that portion of section 2(11) which defines an underwriter:

> "[as] one who 'participates or has a direct or indirect participation in any [distribution of any security by an issuer], or participates or has a participation in the direct or indirect underwriting of any such undertaking.'"

For this holding the Panel cites no authority. The cumbersome statutory language obviously was intended to extend the prohibitions of the Act to peripheral members of underwriting syndicates, or to subject to the prohibitions and penalties of the Securities Act persons aiding issuers or control persons to distribute unregistered securities. If all Congress had intended was to make the seller of any registered securities an "underwriter," it could have found a simpler way of expressing its intention.

The effect of the Panel's decision is likely to reduce the number of transactions in which private placement purchasers "piggy back" on an issuer's registration statement,

with the result that investors will lose the protections of registration and the remedies of section 11, 15 U.S.C. § 77k.

The Panel then holds that "As underwriters [plaintiffs] have no basis for arguing that they should be relieved of the consequences of Tobey & Kirk's failure to deliver a prospectus" with its comparison, citing cases which hold that an issuer or underwriter must find his own exemption and cannot rely on the brokers' exemption merely because he used a broker's services. These cases, United States v. Wolfson, 405 F.2d 779, 782-83 (2d Cir. 1968); SEC v. North American Research & Dev. Corp., 424 F.2d 63 (2d Cir. 1970); SEC v. Culpepper, 270 F.2d 241, 246 (2d Cir. 1959), all dealt with sales of unregistered securities, and simply held that a controlling person who sells is an "issuer" under section 2(11), while one who assists a controlling person in such sales is an "underwriter", and that neither category can claim the broker's exemption for his own acts, merely because he had used a broker. As the Court said in Wolfson, "Control persons must find their own exemptions."

These authorities do not apply to plaintiffs. They registered their shares, and even if they be underwriters they are not seeking to escape their responsibilities as such, since it was not part of their duty as underwriters to deliver any sort of writing to Faulkner. The obligation to deliver a "comparison" was Tobey & Kirk's own obligation as a broker-dealer, and not as a putative underwriter. Moreover, had plaintiffs dealt directly with Faulkner without the interven-

tion of another broker no writing would have been required from them to which section 2(10) could arguably attach. Thus, plaintiffs would not have been required to deliver a prospectus to Faulkner prior to the delivery of the stock on the settlement date. It was only because plaintiffs used a broker to perform the mechanical chores of consummating the transaction that any writing was delivered to Faulkner. That writing was sent by their broker as a broker. Thus, the sole practical effect of the Panel's holding is to discourage selling shareholders in "registered secondaries" from using their own broker, a result which serves no policy of the Securities Act.

Thus, while the cited cases hold issuers or underwriters liable for their own violations of the Act <u>despite</u> their use of a broker, the Panel holds a putative underwriter liable <u>because</u> he used a broker. The Panel's decision thus imposes new and unwarranted liabilities upon sellers of registered stock <u>because</u> they use a broker, while simultaneously denying to both the broker and to the seller the right to invoke the broker's exemption.

POINT II

THE PANEL'S HOLDING THAT TOBEY & KIRK WAS NOT A "BROKER" IS INCONSISTENT WITH THE SECURITIES ACT AND IT MISREADS THE LEGISLATIVE HISTORY OF SECTION 2(10) IN DENYING PLAINTIFFS RELIANCE UPON THE 1941 GENERAL COUNSEL'S OPINION

The Second Defense turns upon section 2(10), which was amended in 1954 to define "prospectus" to include a writing

"which confirms the sale of any security," as well as to writings which "offer any security for sale" (the prior statutory language). In each case the definition does not apply if the writing is accompanied or preceded by a statutory prospectus, or if it is proved that the purchaser already had a prospectus.

In adopting the amendment both Houses of Congress stated that they did not wish to amend by implication the "settled interpretation" of section 2(10). H.R.Rep. No. 1542; S.Rep. No. 1036, 83d Cong., 2d Sess. (1954). The "settled interpretation" was contained in the General Counsel's 1941 Opinion which construed section 2(10), even as originally enacted, to apply to an "ordinary confirmation," i.e., to a confirmation sent by a purchasing broker to his customer on a solicited purchase order (Q and A # 2), but not on an unsolicited purchase order (Q and A # 6). The General Counsel illustrated the principle so enunciated by eleven hypothetical questions and answers, all of which have become part of the legislative history.

Question and Answer # 8 of the General Counsel's Opinion assumes facts virtually indistinguishable from those at Bar, and in them the General Counsel held that no prospectus need be delivered with the broker's "comparison". Question # 8 assumes from previously given facts that the selling shareholder gives his broker an unsolicited order to sell registered warrants which he had received from the issuer, CCH Sec.L.Rep. ¶¶ 3196, 3199, which the broker then sells to a

dealer, "who purchases for his own account". Question and Answer # 8 then state (with our insertions in brackets):

> "Question 8. Pursuant to the [unsolicited] sell order received in Question 7, John Doe [Tobey & Kirk] sells Richard Roe's [plaintiffs' registered] warrants to Henry Hoe, another dealer [Faulkner], who purchases for his own account. Must John Doe [Tobey & Kirk], in confirming the sale to Henry Hoe [Faulkner], or in delivering the warrants to him, send him a copy of the prospectus?
>
> "Answer. No. John Doe [Tobey & Kirk], in making the sale, is completing the execution of an unsolicited brokerage order, and therefore is exempt from the prospectus requirements."

Despite the virtual identity of the facts, the Panel held that Question # 8 does not apply to plaintiffs or Tobey & Kirk for two reasons. The first is because (Slip.Op. 2095):

> "[plaintiffs] were themselves distributing stock in a registered offering, which makes their position quite different from that of the broker in Question No. 8 of the 1941 general counsel's opinion"

With respect, the Panel erred: Tobey & Kirk's position is identical to that of the broker in Question # 8, where, by hypothesis he was selling warrants his customer had received in "a registered offering." As the Commission observed in Matter of Collins Securities Corp., supra, CCH Sec.L.Rep. ¶ 80,327, at p. 85,800 (1975):

> "if an individual acquires 200 shares of an actively traded stock from the issuer and promptly sells them on an exchange, it is clear that registration would be required."

Yet the broker in the General Counsel's hypothetical was not required to deliver a prospectus to the purchasing dealer, and plaintiffs submit that Tobey & Kirk's duty to deliver a prospectus with its "comparison" was no greater than John Doe's.

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The Panel's second basis for distinguishing Question # 8 is (Slip.Op. 2094), that "Clearly Tobey & Kirk was a dealer," rather than a "broker." The Panel justified this conclusion with the following rationale (ibid.): Tobey & Kirk is registered as a broker-dealer with the SEC and is a member of NASD, and section 2(12) of the Act, 15 U.S.C. § 77b(12) defines dealer, inter alia, to include "broker," a term not itself defined in the Act.

We respectfully submit that this conclusion is untenable. Although there is no separate definition of "broker" in the Securities Act, the Act manifestly creates a broker's exemption and the question before the Panel was to determine its applicability. On the Panel's holding one must assume that the section 4(4) exemption can never apply. Yet that could not have been the Panel's intention.

Moreover, on the Panel's holding the distinctions drawn by the General Counsel in his eleven Questions and Answers are meaningless. The General Counsel's Opinion makes quite explicit distinctions: In Questions ## 1 through 5 he is explicitly described as a "dealer", while in Questions ## 6 through 11 he is either described as a "broker" or is hypothesized to be acting solely as "agent." Similarly, the General Counsel's differentiation between Questions ## 8 and 10 is inexplicable save because of the section 4(4) exemption.

Finally, the Panel's reliance upon United States v. Crosby, 294 F.2d 928, 939 (2d Cir. 1961), is misplaced. In Crosby, this Court held that the defendant brokers were

"underwriters" because they bought from controlling persons, and that they were "dealers" because, 294 F.2d at 939-40, "the defendants bought and sold the stock for their own accounts, [and] the exemption accorded 'brokers' transactions' is unavailable." Here, in contrast, it is undisputed that Tobey & Kirk acted solely as agent for plaintiffs, receiving only the normal and customary broker's commission for its services.

It was thus neither a dealer nor, under the penultimate clause of section 2(11), an underwriter. In short, Tobey & Kirk acted as plaintiffs' "broker" within the normal understanding of the securities business, the definition in Rule 144(g), 17 CFR § 230. 144(g), and also in the parallel definitions contained in the Exchange Act, 15 U.S.C. §§ 78c(a)(4) and (5).

There thus seems no justification whatsoever for denying either to Tobey & Kirk or to plaintiffs the protections of the brokers' exemption which the General Counsel had said apply on the facts. The "comparison" was no part of the public offering of plaintiffs' stock---it was sent only as part of a broker's own business.

POINT III

FAR FROM ADVANCING ANY PURPOSE SERVED BY THE SECURITIES ACT, THE PANEL'S DECISION ENCOURAGES FRAUD AND PERMITS MARKET-MAKERS TO ENGAGE IN CONDUCT WHICH IS MANIPULATIVE

The Second Defense succeeds only if Faulkner did not have a White Shield prospectus prior to the delivery to it of

Tobey & Kirk's "comparison." As amended in 1954, the statutory definition of "prospectus" does not apply to a writing if it is proved that the purchaser already had a prospectus. While Faulkner admits that it knew for at least a month before the sale of an impending registered offering of White Shield stock, it claims that it never obtained a prospectus. Obviously it is virtually impossible for plaintiffs to disprove that claim.

Plaintiffs suggested that a "market-maker" which publishing its offers to purchase and sell a security should be presumed to have obtained a copy of the prospectus. While stating that the contention might be "persuasive" in a different factual setting, the Panel found it inapplicable here (Slip.Op. 2097-98):

> "Appellants further suggest that a market-maker who is publishing his offers to purchase may be presumed to have a prospectus. . . . While this argument might be persuasive with regard to shares as to which a registration statement had previously become effective, . . . it does not persuade us in the instant case. Here a registration statement was filed and became effective on the date of the over-the-counter sale."

The Panel's evidently assumed that there was nothing in the transaction to put Faulkner on notice that a registered offering was impending.

However, the Panel thus overlooked admitted facts: The First Defense under Rule 10b-5 itself centers upon the conversations during the week before the sale by which Faulkner's traders repeatedly sought to purchase the stock, and plaintiffs steadfastly refused to sell, admittedly because they were awaiting "SEC clearance" (App. 333-34, 357). It is also conceded that Faulkner knew for a month of an impending regis-

tered secondary in White Shield stock, and that fact also ties into the Fourth Defense, invoking Rule 10b-6 as construed Matter of Jaffee & Co., 44 SEC 285, CCH Sec.L.Rep. ¶ 77,805, at p. 83,858 (1970). Jaffee appears to have imposed a duty upon market-makers to keep themselves informed about registered offerings of securities in which they are making a market so that they will not inadvertently violate Rule 10b-6, as therein construed.

Thus the Panel's stated reason for rejecting plaintiffs' "persuasive" argument is not supported by the facts, presumably because the Panel did not find it necessary to "delve" into these other Defenses (Slip.Op. 2101). Nor is the Panel's reasoning supported by the authorities which the Panel cites.

The effect of the Panel's decision not merely does not advance the purposes of the Securities Act, but it affirmatively immunizes conduct which this Court has held to be inherently manipulative in A. T. Brod & Co. v. Perlow, 375 F.2d 393, 397 (2d Cir. 1967), in which this Court held that it is a manipulative practice to place an order for the purchase of stock with the intention of paying for it only if the price rises, and of rejecting the trade if the price falls. Yet the Panel's decision permits a market-maker to do just that which Brod forbade, since a cancellation of the trade after a price drop, assigning the non-delivery of a prospectus, would impose upon the casual seller the insuperable burden of disproving the market-maker's claim that it had never obtained a prospectus.

At the conclusion of its Opinion, the Panel held that Faulkner's contract with plaintiffs could be voided, by reason of Tobey & Kirk's violation of the prospectus requirements, in order to avoid the circuitousness of sustaining the contract only to enable Faulkner to sue plaintiffs for rescission under section 12(1). It said (Slip. Op. 2099). "it would be anomalous to require that a buyer pay on a contract that violated those requirements and then sue under Section 12(1) to have his money returned."

It is here that the role of Singer & Mackie may be examined to demonstrate the inherent error of the Panel's holding. Whereas Faulkner purchased the stock for its own account, Singer & Mackie's Amended Answer affirmatively alleged that it purchased the entire 1,500 shares as agent for its own customers (App. 61, ¶ 72). Since it was a "dealer" (not on the Panel's holding but because it was actually a market-maker at the time), or because it had solicited the purchase order from its customer, it presumably delivered a copy of the prospectus with its confirmation to its customer, as required by Diskin v. Lomasney & Co., 452 F.2d 871 (2d Cir. 1971). On this hypothesis, Singer & Mackie's customer, having received the prospectus, has no complaint under the Act because Tobey & Kirk failed to deliver a prospectus to his broker. Similarly, Singer & Mackie would have no standing to complain because, by hypothesis, it already had a prospectus.

If the transaction between Singer & Mackie and its customer was an unsolicited purchase order, then Singer &

Mackie might not have been required to deliver a prospectus to its customer because of section 4(4). If so, it should not be heard to complain about Tobey & Kirk's non-delivery of a prospectus to it, since it has sustained no injury whatever.

But because of the Panel's ruling on the law, no one will ever learn what the real facts were concerning Singer & Mackie and its customer, just as no one will ever know if Faulkner really did have a prospectus long before the trade. The Panel's decision involves a needlessly literal reading of section 2(10), one contrary to what Congress deemed to be a "settled interpretation" not to be disturbed, and one which does not advance the purposes of section 5(b), which the Commission said in Matter of Collins Securities Corp., supra, CCH Sec.L.Rep. ¶ 80,327, at pp. 85,802-03 (1975), is the proper test for the applicability of section 2(10).

CONCLUSION

FOR THE REASONS ADVANCED ABOVE THE COURT SHOULD GRANT REARGUMENT EN BANC, AND ON REARGUMENT SHOULD REVERSE THE JUDGMENT BELOW AND DIRECT ENTRY OF JUDGMENT FOR PLAINTIFFS AGAINST FAULKNER

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that on the 14th day of March, 1977, I caused to be served upon counsel for each of the parties hereto two (2) copies of the foregoing Petition for Rehearing En Banc, by depositing same in the United States Mails, addressed to each such counsel at the addresses heretofore given by each of them in prior papers in this Court or Below.

REGINALD LEO DUFF